

Market Commentary

The uncannily accurate January Barometer—based on the premise that as the S&P goes in January, so goes the year—flashed a positive signal in the opening month of 2007, as the S&P 500 Index posted a total return of 1.51%. Market historian Yale Hirsch first identified this indicator in 1972 based on its 18-for-22 (82%) record of accuracy from 1950 to 1971. Since 1972, S&P returns in January have accurately predicted the direction of returns for the full year 27 of 35 times (77%). As is often the case, the indicator’s record of accuracy since its discovery is not quite as good as in the prior period, but it is still pretty impressive. Whether it holds true again this year remains to be seen, but that is the percentage bet, in our view.

TOTAL RETURNS

	Memo Item	
	Jan	5/5/06 - 1/31/07
S&P 500 Index	+1.51%	+10.01%
Dow Industrials	+1.40%	+10.92%
Nasdaq Composite Index	+2.04%	+5.71%
S&P Mid-Cap 400 Index	+3.63%	+2.93%
Russell 2000 Index	+1.67%	+3.29%
Dow Jones Wilshire 5000 Index	+1.90%	+9.21%
S&P 100 Index	+1.09%	+12.37%
Russell 1000 Growth Index	+2.57%	+7.53%
Russell 1000 Value Index	+1.28%	+12.53%

Sources: Bloomberg, Wilshire, Russell

On a sector and style basis, some elements of the market’s performance in January were in keeping with our “New Game” scenario and some were not. The overall market was strong, as was the Nasdaq, and growth outperformed value during the month. Value continues to lead since May 2006, but growth has begun to assert itself since the “New Game” began in August 2006. Not in keeping with our “New Game” scenario was the fact that the S&P Mid-Cap 400 Index surged 3.63% in January, leading the performance derby, while the Russell 2000 Index nosed out the S&P 500 Index and the Dow Industrials. The mega-cap-dominated S&P 100 Index brought up the rear, though it, too, was up a respectable 1.09% for the month.

Taking a bit of a longer-term view—specifically from the early May 2006 peak of the market when we have postulated that the “Old Game” ended—the market is evolving along the lines we expected. As shown in the memo item above, since May 5, 2006, the large/mega cap indices—the S&P 100, S&P 500 and Dow Industrials—have all posted double-digit returns, while the S&P Mid-Cap 400 and small cap Russell 2000 indices are each up about 3%. Considering the fact that the S&P Mid-Cap 400 Index was down from May 5 through year-end 2006, its strong performance in January could be nothing more than a partial catch-up rally in a

lagging group, rather than a sign of renewed leadership. Time will tell which, and we’ll be watching.

General perceptions of the economic backdrop have changed materially in the last couple of months, in our judgment. In early December, consensus expectations seemed to be that fourth quarter real GDP growth would be below 2%, and that weakness in housing and autos might spill over into other sectors and tip the economy into recession. Based on this assessment, 10-year US Treasury note yields bottomed at 4.42% in early December, and the Fed funds futures market was pricing in a high probability of three 25 basis point rate cuts in 2007. As this letter is written in early February 2007, 10-year US Treasury yields have backed up 33 basis points to 4.75%, and the Fed funds futures market is expecting at most one Fed rate cut through the end of 2007.

What happened to change market perceptions was that fourth quarter real GDP growth came in at a robust 3.5%, well above prior expectations. As forecast, the housing and auto sectors were both weak in the quarter, subtracting an estimated 2.3% (combined) from real GDP growth according to former Fed Governor Lyle Gramley. If these preliminary GDP numbers hold up through a myriad of subsequent revisions—which, based on history, is a big if—it will mean that the economy ex housing and autos was cooking along at about a 5.8% growth rate in the fourth quarter. Mr. Gramley believes that the imputed 5.8% GDP figure (ex housing and autos) overstates the true underlying growth rate of the economy due to a number of factors, including a much larger than normal improvement in net exports, a rebound in government purchases following a weak third quarter, and a drop in energy prices that added to consumer purchasing power. Any way you slice it though, it was a good quarter, and certainly much stronger than most had expected.

The strong fourth quarter coupled with continuing early 2007 strength in job growth and consumer spending sets the equity market up for what ISI Group economist Nancy Lazar calls a “growth scare.” In the terminology of the “Goldilocks” metaphor that many have used to describe the US economy, market participants may now begin to worry that the economic “porridge” is “too hot,” and that the Fed may need to cool it off with further rate hikes.

Based upon our reading of their recent public pronouncements, we do not think the Fed is as worried that the economy will overheat as many market participants seem to believe. While acknowledging that “some inflation risks remain,” the Fed’s most recent post-FOMC meeting press release (1/31/07) also stated that “readings on core inflation have improved modestly in recent months, and inflation pressures seem likely to moderate over time.” At the same time, the Fed pointed to signs of “somewhat firmer economic growth” and “tentative signs of stabilization” in the housing market. Taken as a whole, we think the Fed seems to believe the economy is neither

strong enough to warrant tightening nor weak enough to warrant easing and that, therefore, its best course of action for the time being—and perhaps for some time to come—is to sit on the sidelines.

Obviously, the Fed will be watching many variables in determining the optimum course of future policy initiatives. We believe one factor may rise above all others in influencing the Fed's thinking. In real estate, it is said that the three most important factors to consider are: location, location and location. In deciding the likely course of Fed policy, we would argue that the three most important things to watch are: productivity, productivity and productivity.

To us, productivity is the “secret sauce” of economic growth. It is the key factor in allowing the economy to grow at a healthy pace without triggering inflationary pressures. Productivity growth averaging in excess of 2% in recent decades is the main reason, in our judgment, why recessions have been relatively short and relatively rare over that time frame. When productivity drops below 2% for an extended period, it becomes far more likely that wage pressures will lead to a generalized rise in inflation. It is in this context that we were so heartened to see that productivity grew at a healthy 3% in the fourth quarter of 2006. One quarter does not a trend make, and future readings clearly bear watching, but the fourth quarter productivity number was awfully encouraging.

Outlook

We continue to see few reasons to be anything but optimistic about the outlook for the US equity market in 2007. That does not mean that we could not undergo a market correction at any time, perhaps even soon. It also doesn't mean that market volatility might not increase from the unusually low level of last year. What it does mean, though, is that our best thinking is that the bull market that began in 2002 continues, and therefore, we should remain bullish.

Our formula for market returns in 2007 remains the same as it was thirty days ago—earnings growth plus dividends plus some degree of P/E multiple expansion. The extent of multiple expansion remains the big swing factor, in our opinion.

The recent back up in long rates argues somewhat against the very high end of our bullish-to-very-bullish forecast range. Because the value of a stock is the discounted present value of its future free cash flows, it is a mathematical truism that stocks are worth less when the discount rate (the 10-year US Treasury yield in our calculations) is 4.75% (as it is now) than when it is 4.5% (as it was in December). Of course, the long rate at any given point in time is only a proxy—but in all likelihood the best proxy available—for what one really wants to know, which is what long rates will average over the forecast horizon. That said, a 25 basis point back up in long rates, should it be sustained and all other things being equal, implies that stocks are worth about three-quarters of a multiple point less than before. Based upon our previously enumerated assumptions (which have not changed in over a year), we believe fair value for the S&P 500 Index is about 16.1 times 2007 earnings per share, down from 16.9 times

when long rates were 4.5%. Given that the S&P 500 currently trades at about 15.3 times 2007 earnings, the upside to fair value is now about 5%.

Whereas the market's P/E multiple expansion potential may have been diminished a bit in the last 30 days, its growth outlook may have actually been enhanced. Bottom-up, cap-weighted consensus earnings per share growth for 2007 is 8.3% currently. Our base case had assumed a slowdown in earnings growth to about 7%. If GDP growth turns out to be stronger than expected this year, earnings growth will likely be better as well.

Apart from the fundamental arguments—with which we disagree—that interest rates and inflation are headed much higher or that earnings are in for a tumble, the principal bear case seems to center around the idea that investors are too optimistic or that we've gone “too long” without a meaningful correction and, therefore, a market downturn is “overdue.” As regards the state of investor sentiment, while we concede that investors seem more optimistic now—after a big market rally—than they did in the summer of last year, it could hardly be otherwise. Investors were deeply pessimistic last summer and while their mood has improved since, it seems far from ebullient. As Ned Davis noted in a recent hotline (2/7/07), domestic-oriented equity mutual funds saw net redemptions for the seventh time in eight months in December, and the percentage of Fidelity Select Fund assets in the money market fund has climbed above the levels seen in 2002 (at the bottom of the last bear market). In addition, individual investors have remained cautious throughout the entire market rally since last July, according to American Association of Individual Investors (AAII) polls. These statistics suggest that many individual investors remain very skeptical of the equity market in general, and the latest rally in particular. We regard this as a healthy state of affairs.

Other statistics that we have seen cited in several places recently relate to the length of time that the Dow Industrials have gone without a significant correction. For example, Ned Davis is cited in *The Wall Street Journal* (1/30/07) as noting that the Dow Industrials have gone 978 trading days without a 10% decline from a prior high, the second longest such run on record. We're curious to know what happened after the first such run and are investigating.

The *Journal* article further noted that the Dow Industrials had gone 135 trading days without a daily decline of 2% or more, the longest such stretch since 1958. Based on our analysis using daily closing prices downloaded from Bloomberg, this latter statement is almost certainly incorrect. Our work shows that the last daily decline in the Dow Industrials *approaching* 2% was the 1.96% decline on January 20, 2006, a period of 258 trading days through month-end January 2007. The last time the Dow declined 2% or more from closing price to closing price was May 19, 2003, 932 trading days ago through month-end January. Since 1954, this is the longest period without a 2% daily decline in the Dow Industrials. Does the fact that the Dow has gone such a long time without a daily decline of this magnitude make it especially vulnerable now? This certainly seems to be the inference of those who make this type of observation. To see if we could determine whether or not the Dow is vulnerable, we again looked at the historical data.

Dow Industrials
Two Percent Daily Declines Since 1954
Separated by More Than 400 Trading Days

Date of Decline	Trading Days Since Last Decline	Price Change* 6 Mos. Later	Price Change* 12 Mos. Later
9/23/57	491	-1.41%	+14.58%
10/3/66	720	+13.46%	+21.97%
5/4/70	873	+7.87%	+31.33%
11/9/73	855	-4.69%	-26.56%
7/27/77	415	-13.99%	-4.26%
1/8/86	484	+19.27%	+31.16%
	640	+3.42%	+11.37%

* Excludes dividends
Source: Bloomberg

Since 1954, we identified six periods prior to the current one during which the Dow Industrials suffered no daily declines of 2% or more for at least 400 consecutive trading days. The table above lists the dates of those six instances, along with the closing price of the Dow on each date and the price change in the Dow for the subsequent six- and twelve-month periods.

Our conclusion from the data above is that it is hard to draw firm conclusions. An extended period without a 2% or greater daily decline in the Dow Industrials was followed four times by a good market, and two times by a bad one. On average, the subsequent returns following such occurrences are slightly above average for the six-month period and well above average for the twelve-month period. So, if anything, one might reasonably conclude that long stretches without a 2% daily decline are more likely to be a good thing than a bad thing as far as future market returns are concerned.

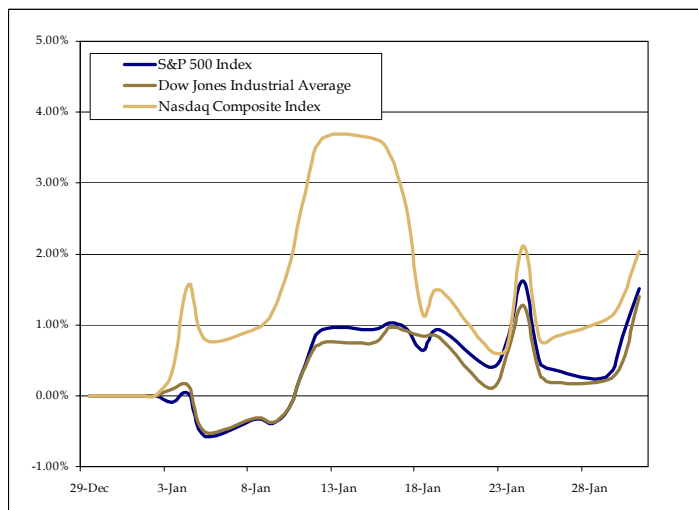
Our point in going through this exercise is that we believe it's important to get one's facts straight. What one reads in the newspapers is not always true, and even if it is true, it doesn't necessarily mean what the writer suggests that it does.

To recapitulate our current views, we certainly have not given up entirely on the possibility of 20% or greater total returns for the S&P 500 Index for 2007. In our view, the back up in long rates makes it somewhat less likely than before. Still, the year is only one month old, so much of the story has yet to unfold. If long rates renew their decline, the market's upside will be enhanced. In any case, the argument for solid total returns in 2007 remains strong, in our opinion.

As always, we thank you for your support and welcome your comments.

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Legg Mason Capital Management

Major Indices January Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	January
<i>Broad Market Indices</i>	
S&P 500	1.51
Dow Jones	1.40
Russell 1000	1.93
NASDAQ	2.04
Dow Jones Wilshire 5000	1.90
Russell 2000	1.67
Russell 1000 Growth	2.57
Russell 1000 Value	1.28
<i>S&P 500 Sector Indices</i>	
S&P 500 Consumer Discretionary	2.78
S&P 500 Consumer Staples	1.98
S&P 500 Energy	(1.84)
S&P 500 Financials	0.88
S&P 500 Health Care	3.09
S&P 500 Industrials	1.34
S&P 500 Information Technology	1.58
S&P 500 Materials	4.60
S&P 500 Telecomm Services	3.90
S&P 500 Utilities	(0.29)

Sources: Bloomberg, FactSet, Russell

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